NO. 15031

United States
COURT OF APPEALS
for the Ninth Circuit

Estate of HERBERT B. MILLER, Deceased, UNITED STATES NATIONAL BANK OF PORTLAND, (Oregon), Administrator, d.b.n., c.t.a.,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITIONER'S OPENING BRIEF

Petitions to Review the Decisions of the Tax Court of the United States.

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Petitions to Review the Decisions of the Tax Court of the United States.

STATEMENT OF JURISDICTION

The Petitions for Review of the Decisions of the Tax Court of the United States in Docket Nos. 28582 and 31063 by the United States Court of Appeals for the Ninth Circuit were filed pursuant to Sec. 7482 and Sec. 7483, Internal Revenue Code of 1954 (Tr. 59, 60).

STATEMENT OF THE CASE

Herbert B. Miller, the decedent, died on February 13, 1948, a resident of Milwaukie, Oregon (Tr. 23).

Prior to June 1, 1946, decedent and his two brothers, Ernest Miller, Jr. and Walter M. Miller, were equal partners in a paint manufacturing and marketing business in Portland, Oregon, doing business as Miller Paint Co. The assets of the firm consisted of personal property, accounts receivable and cash. The real estate occupied by the firm was rented from Miller Paint and Wall Paper Co. another co-partnership composed of the same three persons (Tr. 25).

Blanche M. Miller is the widow of decedent. Some time in 1944 she was informed by a physician that her husband, Herbert, had cancer and could live only a few years longer. Ernest and Walter were informed of this but none of them told the decedent and it is not apparent whether he ever became aware of his condition (Ex. 12, Tr. 125, 130).

Ernest and Walter Miller were aware of his illness and realized the importance of taking steps to preserve the continuity of the business to provide an estate for Herbert B. Miller, independent of the Herbert B. Miller Company co-partnership for the benefit of Herbert Miller's widow and son, and to avoid complications in the probate of their brother's estate (Tr. 106, 112).

Decedent was the only partner with children (Ex. 15). Ernest was married, but had no children; Walter was unmarried.

In late 1945, the partners conferred with trust officers of the United States National Bank to the best method of accomplishing the end sought and were advised to have purchase provisions incorporated in a partnership agreement with wills containing trusts (Tr. 103, Ex. 24).

Independent counsel, however, was also consulted and this counsel in turn consulted tax counsel as to the tax effect of the proposed transaction as hereinafter related as the plan developed (Tr. 82, 98, 99).

The three brothers desired an arrangement whereby death or incapacity of a partner would not affect the continuity of the business; that the business could carry on free from interference in case of possible complications in the eventual probate of a partner's estate (Tr. 82) and an estate could be created, independent of the partner's interest in Miller Paint Co., for the benefit of the decedent's family in case of his death (Tr. 83). In addition, Ernest Miller desired to incorporate the Miller Paint Co. business so that he could leave his share of the business to some of his old employees (Tr. 107), without disturbing the continuity of management (Tr. 83).

Upon advice of counsel, the Miller brothers were advised that a corporate organization (Tr. 83) would best preserve the continuity of the business (Tr. 83), would avoid complication of the probate of any estate of any of the partners, would allow greater flexibility in the eventual disposal of interest in the Miller Paint Co. to its employees, and would allow each of the brothers to create an estate in themselves and for the benefit of

those to whom they wished to dispose of their property, substantially equal to the value of their share in the physical assets of the partnership (Tr. 82, 83, 111, 112, 126).

In the years immediately prior to June 1, 1946, earnings had been high (Tr. 112, Ex. 10-L). No evidence was presented suggesting any doubts at that time that the prosperous condition of the business would continue.

In accordance with the plan to incorporate the business, Miller Paint Co., Inc. was organized pursuant to laws of the State of Oregon on or about May 13, 1946. The charter was received on May 18, 1946. Total authorized capital stock consisted of three hundred shares of no par stock. Each partner subscribed for one hundred shares at a stated value of $3.50 per share. The shares were issued on May 20, 1946 (Tr. 27, Ex. 9-K). Oregon law requires that a corporation with no par stock have a capital investment of at least $1,000.00 (Tr. 71). Each party paid for the stock subscribed for, in cash, from his respective personal bank account (Tr. 7, Ex. 9-K).

The new corporation acquired a large portion of the assets of the partnership. It succeeded to the paint selling and manufacturing business and obtained its good will. All of the tangible assets, including inventory, equipment and fixtures of the partnership were acquired. The agreed fair market value of the physical assets acquired on June 1, 1946, was as follows:

	Fair Market Value June 1, 1946
Inventory	$60,122.49
Machinery and Equipment	15,000.00
Furniture and Fixtures	3,000.00
Delivery Equipment	7,500.00
Office Equipment	1,000.00
Total	$86,622.49

The adjusted basis of the same assets in the partnership as of May 31, 1946, was lower, to-wit, $73,255.-14 (Tr. 27, 28).

The corporation also acquired from the partnership its accounts receivable, petty cash and change fund, and some unearned insurance premiums and assumed certain trade accounts payable of the partnership, as follows (Tr. 28):

Petty Cash and Change Fund	$ 598.00
Accounts Receivable	89,328.54
Unexpired Insurance	636.40
Total	$90,562.94
Less: Accounts Payable	52,614.17
Balance	$37,948.77

During the first meeting of the Board of Directors, held on May 20, 1946, it was resolved that the corporation borrow $50,000.00 from Ernest Miller, Jr., H. B. Miller and Walter Miller at an interest rate of five per cent per annum and that the corporation execute a promissory note in the usual form as evidence of such indebtedness and payable on or before three years after date (Ex. 25), which note dated June 1, 1946, was issued (Ex. 17).

At another meeting held on June 3, 1946, it was resolved that the corporation purchase from the partners, at inventory value, all of the partnership's machinery, equipment, store fixtures, automotive equipment and stock of goods, wares and merchandise as per close of business as of May 31, 1946, the corporation agreeing to pay the inventory price or fair market value thereof and that the corporation execute and issue a promissory note to the three partners payable at the rate of $20,000.00 per year, plus interest at the rate of five per cent per annum on the unpaid balance, the first of said payments to be made on or before June 1, 1947 (Ex. 25).

At the same meeting (Ex. 25) it was determined that the fair market value of the goods, wares, merchandise, furniture, fixtures, machinery and equipment being purchased by the corporation, was $86,622.49 (Tr. 28). This purchase was evidenced by a promissory note in the same amount issued by the corporation payable to all three former partners (Ex. 17).

Another resolution, at the same meeting (Ex. 25) called for the purchase, by the corporation, of certain intangible assets of the firm subject to liability. The fair market value thereof was $37,948.77 and a note in that amount was issued payable to all three partners on or before six years after date, plus interest on any unpaid balance at the rate of five per cent per annum from the date of the note, interest payable annually (Ex. 17).

At the same meeting (Ex. 25) the Directors further resolved that the corporation execute and deliver a

chattel mortgage encumbering the corporation's personal porperty as security for the payment of the two aforementioned notes of $86,622.49 and $37,948.77 (Ex. 25). This mortgage was executed and delivered (Ex. 13).

Accordingly, in the final return of Miller Paint Co., a co-partnership, the partnership reported a net gain on its fixed assets sold to the corporation, the net gain being the difference between the depreciated or adjusted value thereof and the fair market value at the time of sale (Ex. 1-A). This gain in the amount of $6,683.68 was proportionately reflected and reported as a long term capital gain upon the partners' individual income tax returns (Ex. 2-B).

The transaction also resulted in recovery for bad debts in the partnership which was reported by the partnership in the final partnership return as a short term gain in the amount of $5,268.81 which, in turn, was reported as income upon the partners' individual income tax returns (Ex. 1-A, 2-B). The Commissioner, however, upon audit, treated the recovery as ordinary income (Ex. 8).

At a subsequent meeting of the Board of Directors on June 31, 1946, it was resolved to reissue the notes of the corporation wherein all three of the Miller brothers were named as payees for notes and which each individual would hold notes for one-third of the previous notes (Ex. 25). Accordingly, and in lieu of the note in the amount of $37,948.77 and the note of $50,000.00 payable to the partners jointly, separate notes were issued in the sum of $29,316.26 payable to each of the partners

six years from date and bearing interest at five per cent payable annually (Ex. 19).

At the same time and in lieu of the original note payable to the three partners in the sum of $86,622.49, three separate notes in the amount of $28,874.16 were issued payable to the individual partners in annual installment of not less than $6,666.68 together with interest at the rate of five per cent (Ex. 18).

It was further resolved that the chattel mortgage previously issued stand as security for the payments of these notes (Ex. 25).

The books of the partners (Ex. 26) and of the corporation (Ex. 27, 28) reflected the foregoing transactions. Upon dissolution of the partnership, the partnership had on hand $98,720.15 in cash which was owned equally by the partners (Ex. 1-A).

Between January 1st and May 1st, 1946, gross receipts of Miller Paint Co. co-partnership were $329,-528.09 (Ex. 1-A). The corporation had gross receipts of $403,809.06 between June 1st and November 30, 1946 (Ex. 4-D). During the fiscal year ending November 30, 1947, gross sales totaled $864,540.75 (Ex. 5-E).

No dividend has ever been declared by the corporation (Tr. 109).

In 1946 and 1947, decedent received from the corporation, as payments upon the principal of the note for the $28,874.16, the sums of $7,500.00 and $10,000.00 from Miller Paint Co., Inc. Equal amounts were paid to Walter M. Miller and Ernest Miller, Jr. The item of

"notes payable" on the balance sheet of the corporation of $174,571.26 was reduced in amounts comparable to the foregoing payments of the respective shareholders (Tr. 27, 28).

It is these payments that are at issue, the Commissioner contending that the payment of these amounts constitute a taxable dividend to the decedent to the extent of the available earnings of the corporation.

Herbert B. Miller died from cancer on February 13, 1948 (Ex. 12), leaving a Last Will and Testament (Ex. 15) which provided, generally, that his entire estate, including the notes and stock in Miller Paint Co., Inc. would be placed in trust with the United States National Bank of Portland (Oregon) and that the net annual income of the trust estate be paid in monthly installments to his widow, Blanche M. Miller, during her life. In the event of the widow's death, the son not having reached the age of thirty years, one-half of the estate in cash or kind or both was to be distributed to testator's son and the remaining half is distributable to him when he attained the age of thirty years. However, the widow, has, under the will, the right to accelerate the distribution of the Miller Paint Co., Inc. stock to her son. This right to accelerate the vesting of stock in the son applies only to the stock and has no application to the remainder of the trust estate including the notes in question (Ex. 15).

The Executor of the decedent's estate included in the Inventory and Appraisement filed in the Circut Court of the State of Oregon, County of Multnomah,

Department of Probate, Clerk's No. 59444 (Ex. 14) and in its Federal Estate Tax Return on Schedule C, Page 2, Item VII and VIII (Ex. 6-F), as an asset of the estate, the promissory notes issued to the decedent. The principal balance due on the note in the face value of $28,-874.16 was the sum of $11,374.16 and the other $29,319.-26. Federal Estate Tax was paid on these values.

The Executor further included, in the Inventory and Appraisement and in the Federal Estate Tax Return of the decedent at Schedule D, Page 2, as an asset of the estate, one hundred shares of Miller Paint Co., Inc. capital stock, no par value, at $347.78 a share (Ex. 14, 6-F), which value was predicated entirely on the average earnings of the partnership and the corporation projected over a period of ten years with an allowance for management and capitalized at the rate of twenty per cent (Tr. 30, Ex. 10-L).

The formula would be as follows:

$$\frac{\text{Average Net Income} \times 5}{\text{300 Shares}} = \text{Fair Market Value of 1 Share}$$

$$\frac{\$20{,}866.76 \times 5}{300} = \$347.78$$

Under the foregoing statement of facts, this case involves the following questions:

(1) Did payments made by Miller Paint Co., Inc. to Herbert B. Miller, upon the principal of a promissory note held by the taxpayer constitute dividend income to the taxpayer.

(2) Was the transaction which transferred the assets of Miller Co., a co-partnership to Miller Paint Co., a tax free exchange within the meaning of Sec. 112 (b)(5) Internal Revenue Code, 1939.

SPECIFICATION OF ERRORS

1. The Tax Court erred in holding that a deficiency exists with respect to the deceased, Herbert B. Miller's personal income taxes for the taxable years ending December 31, 1946, and December 31, 1947, when in truth and in fact there was no deficiency.

2. The Tax Court erred in holding that payments made upon the principal of promissory notes held by the deceased and issued by Miller Paint Co. constituted taxable dividends within Sec. 115(a) of the Internal Revenue Code, 1939, to the extent of the available earnings and profits of the corporation when in fact said payments constituted a return of capital.

3. The Tax Court erred in holding that the sale of various assets of a predecessor corporation at market value to Miller Paint Co., Inc., together with a contemporaneous loan of cash and the issuance by the corporation of notes payable to the decedent partner in payment thereof was a transfer of assets "solely in exchange for stock or securities" within the non-recognition of gain or loss provisions of 112(b)(5) of the Internal Revenue Code of 1939.

4. The Tax Court erred in holding:

(a) The sum represented by the declared value of the capital stock of Miller Paint Co., Inc. was grossly inadequate to operate business;

(b) The lowest stated value of the capital stock was a fiction.

(c) The risk capital actually contributed to the corportation was represented by the operating assets and cash of partnership;

(d) No bonafide indebtedness was created by the notes issued by the corporation to the decedent partner; and

(e) The true consideration for the cash and operating assets was the capital stock issued to the decedent partner;

When in fact:

(a) Miller Paint Co., Inc. was adequately capitalized;

(b) The consideration for the capital stock was the sum of $1,050.00;

(c) The risk capital actually contributed to the corporation was represented by the capital stock alone;

(d) A bonafide indebtedness providing temporary financing for the corporation was created by the notes issued by the corporation to the partners.

(e) The true consideration for the cash and operating assets of the partnership was represented by the notes issued to the partners.

5. The Tax Court erred in finding that there was no bonafide intention to affect a true debtor-creditor relationship and that they intended to be investors in the corporate business to the full extent of all value contributed by them, when in fact, the taxpayer intended to create a debtor-creditor relationship between himself and the corporation and to extract from the business the capital that he had invested therein.

6. The Tax Court erred in holding that the substance of the business transaction at issue was not identical to its form when in truth and in fact the substance of the business transaction was identical to its form.

7. The Tax Court erred in holding that the form adopted by the taxpayer partners in capitalization and financing of the corporation had no business purpose, when in truth and in fact there was a business purpose.

8. The Tax Court erred in holding that the notes are a mere sham and have no reality when in fact the notes were impeccable in form and were consistently treated as representing indebtedness owned by the corporation to the decedent taxpayer.

9. The Court erred in determining that as a matter of law, the payments made by Miller Paint Co., Inc. to Herbert B. Miller, upon the principal of a promissory note held by the taxpayer constituted dividend income to the taxpayer when, as a matter of law, said payments constituted return of principal.

The Tax Court erred in determining, as a matter of law, that the transaction at issue constituted a tax free

exchange of partnership assets for stock in the corporation within Sec. 112(b)(5) I.R.C. 1939, when as a matter of law, there was a sale of assets for notes.

SUMMARY OF ARGUMENT

The form of the notes and of the corporation of Miller Paint Co. gave clear evidence that the notes are evidence of indebtedness. They are impeccable in form, are short-term, have a definite maturity date and not subordinated to the claims of the corporation's general creditors.

The intent of the participants in the transaction was to create an indebtedness rather than a permanent capital investment. As evidencing this intent, taxpayer, had a business purpose in financing the Miller Paint Co., Inc. by using indebtedness instead of capital stock, as he desired that the capital that he was loaning to the corporation be returned to his estate and did not desire that the return of this capital either to himself or his estate to be subject to income taxes. The intent of the taxpayer was evidenced by his consistent treatment of the notes as evidence of indebtedness both by the prompt payment of the same in accordance with their terms, the inventory of the notes as a separate item in his estate and their inclusion in his Federal Estate Tax return. The corporation was not thinly capitalized, as there was additional consideration transferred to the corporation, represented by notes consisting of good will and the right to receive high earnings in the coming years.

The Tax Court's finding that the notes were sham is essentially a charge of fraud which is not supported by the pleadings or evidence.

The finding of the Court that the sale by the partnership to the corporation of the partnership assets was a nontaxable transfer contradicts the express provisions of the Internal Revenue Code with respect to nonrecognition of gain or loss and was contrary to the intent of the parties.

No matter what the conclusion of the Court may be as to whether the notes are sham, the facts indicate that payments on the principal of the notes are a return of capital which is neither a dividend nor essentially equivalent to a dividend within the meaning of the Internal Revenue Code.

ARGUMENT

Point 1

The form of the notes and of the incorporation of Miller Paint Co., Inc., gives clear evidence that the notes are evidence of indebtedness.

No evidence was offered by the Commissioner to controvert or cast doubt upon the bona fide character of the notes issued by the corporation to the taxpayer.

This was recognized by the Tax Court where in its opinion (Tr. 42) the Court said:

> "The form of the notes in the instant case presents no such problem. These notes standing by themselves, are clear evidence of indebtedness."

In fact, the evidence in the case is replete with facts testifying to the impeccable form of this transaction.

(a) All of the capital stock issued by the corporation was paid for in cash by the taxpayer and his brothers by checks drawn upon their personal, as distingushed from their partnership, bank accounts (Tr. 27).

(b) The minute book of the corporation which records the entire transaction gives evidence of a sale by the partners to the corporation and the creation of a debtor-creditor relationship with respect for the payment for these partnership assets (Ex. 25).

(c) The physical assets of the partnership were revalued at their fair market value for the purpose of sale (Ex. 25) and the gain was recorded on the books of the partnership (Ex. 26) and reflected in the individual tax returns of the taxpayer (Ex. 2-B) and his brothers. The opening entries on the books of the corporation reflect the existence of "Notes Payable Officers", "Interest Expense", "Capital Stock" and the stepped-up value of the physical assets acquired from the partnership by the purchase (Ex. 27).

(d) The indebtedness of the corporation created by the purchase of the current and fixed assets of the partnership and the $50,000.00 cash loan was secured by a chattel mortgage in favor of the former partners (Ex. 13). There was no subordination of the indebtedness to the general creditors. In fact, the converse was true.

(e) The interest and principal on the notes were payable unconditionally, whether earned or not and

were not payable only at the discretion of the Board of Directors (Ex. 18, 19, 25).

(f) The notes were short form and had fixed maturity dates (Ex. 18-19).

The fact that the principal of the loans was secured by a chattel mortgage and was not, therefore, subordinated to the claims of other creditors, is evidence that a debtor-creditor relationship was created. *B.M.C. Manufacturing Corporation,* 11 TCM 376, *cf. Anderson Corp.,* 5 TCM 392 (1946) where the Commissioner was unsuccessful in attempting to treat indebtedness secured by a first mortgage on real estate as stock.

In *Comm. v. O.P.P. Holding Corp.,* 76 Fed. (2d) 11 (CA 2, 1935), Judge Swan said:

> "We do not think it fatal to the debenture-holder's status as a creditor that his claim is subordinated to those of general creditors. The fact that ultimately he must be paid a definite sum at a fxied time marks his relationship to the corporation as that of creditor rather than shareholder. The final criterion between creditor and shareholder we believe to be the contingency of payment."

The above is quoted in *Comm. v. Page Oil Co.,* 129 Fed (2d) 748, (CA 2-1942). See also *The Bowersook Mills & Power Company v. Comm.,* 172 Fed (2d) 904 (CA 10-1949) and *John Kelly & Company v. Comm.,* 326 U.S. 521 (1946).

As opposed to a stockholder relationship, the most significant, if not the essential feature of a debtor-creditor relationship, is the existence of a fixed maturity date of the obligation with the right to enforce payment:

Wilshire & Western Sandwiches, Inc., 175 F(2d) 718 (1949); *Bonds, Inc.*, TC Memo Op. Dk. 5074 (N. 1944); *Jordan Co. vs. Allen*, 85 Fed. Supp. 437 (D.C.N.D., Ga., 1949); *Universal Oil Products Co. vs. Campbell*, 181 F(2d) 451 (CCA 7th, 1950), *aff'd. on this point*: 40 A.F. T.R. 1328 (D.C.N.D.) Ill. 1949; *Commissioner vs. Schmoll Fils Associated, Inc.*, 110 F(2d) 611 (CA 2d 1940); *U. S. vs. South Georgia Ry. Co.*, 107 F(2d) 3 (CA 5th 1939); *Idaho Dept. Store, Inc.*, TC Memo Op. Dk. 923 (1944).

While consitency and nomenclature are not controlling, they have some evidenciary value, and in absence of other proof, they raise a presumption as to the nature of the investment. *Pierce Estates, Inc.*, 16 TC 1020; *Estate Planning Corp. vs. Commissioner*, 101 F(2d) 15 (CCA 2d, 1939); *Alma de B. Spreckles*, 8 TCM 113 (1949).

Indeed, as a matter of form, what more could the taxpayer have done to legally create an "indebtedness" as distinguished from a "permanent capital investment in stock?"

Point 2

All evidence indicates the intent of the participants in the transaction was to create an indebtedness rather than a permanent capital investment.

With respect to whether a debtor-creditor relationship exists, the intent of the parties as to the nature of the transaction controls: *Wilshire & Western Sandwiches, Inc.*, 175 F(2d) 718, (CA-9, 1949); *Elliott-Lewis*

Corp. Co., Inc., TC Memo Op. Dk. 3275 (1949) aff'd. 154 F(2d) 292 (CCA 3d, 1946); *Harvey Investment Co. vs. Scofield*, U.S. Dist. Ct. W.D. Texas 45 A.F.T.R. 899, (1953); *1432 Broadway Corp.*, 4 TC 1158 (1945), aff'd. per curiam, 160 F. 2d 885 (CCA 2d, 1947); *Kipsborough Realty Corp.*, 10 TCM 932 (1951).

The elements of a debtor-creditor relationship are a meeting of the minds as to the intent of the nature of the events; transfer of the consideration, and a promise to pay, evidenced by negotiable promissory notes presenting an unconditional and legally enforcible obligation for the payment of money. *Wilshire & Western Sandwiches, Inc.*, 175 F(2d) 718 (1949).

(a) The taxpayer had a business purpose in financing the Miller Paint Co., Inc. by using indebtedness instead of capital stock.

The decedent, Herbert B. Miller, had a wife and minor child for whom he had to provide support. Although it is not known whether or not he knew that he had cancer, he did know that he was sick and should get his estate in order (Tr. 130).

The decedent, in 1946, had substantially all of his assets tied up in the Miller Paint Co., a co-partnership consisting of himself and his brothers. The continuity of the business in the event of his death was the concern of all of the partners including the decedent (Tr. 82, 83, 102, 112, 40).

All of the evidence leads to the conclusions that the business purpose of the taxpayer was to:

(1) Simplify the administration of the estate of a deceased partner;

(2) To insure the continuity of the business in the event of the death of one of the partners; and

(3) To create in the estate of decedent partner, and particularly of the taxpayer, who had a widow and minor child to think of, a fixed obligation on the part of the corporation to pay the partners the value of the assets that they had sold to the corporation and so provide the partner and his estate with assured income for a period of years, a liquid and enlarged estate, and an extraction from the paint business of the monies and assets upon which the partner had already paid income taxes.

If taxpayer, as the United States National Bank had suggested, had executed a buy and sell agreement between himself and his brothers, taxpayer could not reasonably have been expected to receive full value for the good will of the business which was expected to increase in value considerably in the next few years. It would not be reasonable for taxpayer to execute such an agreement, as this might, in all probability, foreclose any possibility of his son having a place in the firm.

From taxpayer's point of view, the only feasible method to accomplish his desires was to incorporate and once this decision was made, he was faced with the problem as to how to assure an adequate estate, the income from which would provide for his wife and child.

He could have no assurance that the corporation would ever pay a dividend. As a matter of fact, the evi-

dence shows that no dividend has ever been paid by Miller Paint Co., Inc. Under these circumstances, the only feasible method of being assured that his capital interest in the partnership would be repaid to his estate was to create an indebtedness from the corporation to himself and to his estate by the use of notes.

After the original intention was formed to create a corporation, the tax effects of the contemplated method of financing and organizing a corporation were examined (Tr. 38, 39).

In determining whether payments made in debentures issued for exchange of capital stock would be treated as interest or dividends, the Courts have held that the business purpose test is not determinative and the stockholders have a right to change or create a debtor-creditor relationship, though the reason may be purely personal to the parties concerned. *Toledo Blade Co.*, 11 TC 1079; *affirmed on other grounds* 182 F(2d) 357 (CA 6th, 1950). Other cases of similar import are: *Clyde Bacon, Inc.*, 4 TC 1170 (1945); *Cleveland Adolph Mayer Corp.*, 6 TC 730 (1946); *Stirn, Inc.*, 107 Fed. (2d) 390 (CCA 2d, 1937); *Lloyd Smith*, 116 F(2d) 642 (1941); *Pinella Ice and Cold Storage Co. vs. Commissioner*, 53 S. Ct. 257, 287 U.S. 462 (1933).

Later, in *New England Lime Co., Inc.*, 13 TC 799 (1949), the Tax Court held that the presence of a business purpose other than the saving of taxes (in changing from stocks to debentures) was a factor favorable to debt recognition. Again in *H. E. Fletcher Co., Inc.*, 10 TCM 1025 (1951) involving a conversion of preferred stock to notes, the Court said:

"Unless tax saving is the sole purpose there is nothing to prevent a taxpayer from exchanging an instrument of proprietorship to one of indebtedness."

In *Ruspyn Corporation,* 18 TC 135 (1951) (*Comm. Acq., Int. Rev. Bull. 1952-24*) involving the incorporation of partnership real property in exchange for stock and debt, the Court included in its enumeration of factors favorable to debt recognition, the presence of a "good business reason for the issuance of debt securities and found the reason for incorporating the desire on the part of the incorporators to bring about a unity of title the better to deal with tenants. The Court went on to state:

"We feel perfectly sure from the facts which have been stipulated and from the oral testimony that when petitioner was organized and it issued 6000 shares of common stock with par value $100, and $2,100,000 face value debentures in payment of real estate which it acquired from the owners, it fully expected to be able to pay the interest on its debenitures and to have something substantial left over for distribution to stockholders as dividends on its common stock. Therefore the fact that events which happened after the widespread depression made it impossible for petitioner to collect the rents which it had anticipated does not throw any shadow on the bonafide of its stock and debenture issues."

We finally come, however, to *Kraft Foods Co. vs. Commissioner,* 21 TC 513 Revsd. — F(2d) — (CA-2 1956).

In this case, the taxpayer, a subsidiary corporation, declared a $30,000,000.00 dividend to its parent corporation and cast the dividend in the form of debentures payable to the parent company bearing interest.

The Commissioner contended that the debenture issue should be disregarded for tax purposes because it served no business purpose other that the minimization of taxes, i.e. the deduction by a taxpayer of interest upon debentures as a business expense. The Court posed the following question:

> "Assuming, then, that the purpose of the transaction was to minimize taxes, should the transaction be disregarded because of its tax motivation?
>
> "The Commissioner argues that transactions, though formally perfect that in compliance with the provision of the tax statute, must be disregarded if they have no purpose germane to the conduct of the business other than tax minimization. He relies on *Gregory vs. Helvering,* 1935, 239 U.S. 465 (14 AFTA 1191); *Minnesota Tea Co. v. Helvering,* 1938, 302 U.S. 609 (19 AFTR 1258); *Griffiths vs. Commissioner,* 1939, 308 U.S. 355 (23 AFTR 784); *Higgins v. Smith,* 1941, 308 U.S. 473 (23 AFTR 800); *Commissioner v. Court Holding Co.,* 1945, 324 U.S. 331 (33 AFTR 593); *Bazley v. Commissioner,* 1947, 331 U.S. 737 (35 AFTR 1190); *Commissioner v. Culbertson,* 1949, 337 U.S. 733 (37 AFTR 1391). "We do not think that these cases hold that tax minimization is an improper objective of corporate management; they hold that transactions, even though real, may be disregarded if they are a sham or masquerade or if they take place between taxable entities which have no real existence. The inquiry is not what the purpose of the taxpayer is, but whether what is claimed to be, is in fact. As Judge Learned Hand in *Loewi v. Ryan,* 2 Cir., 1956, — F.2d —, —, '* * * the Act is to be interpreted against its own background, and in deciding how far it adopted all legal transactions that the state law may have covered, it was proper to exclude those that had no other result than to evade taxation. The purpose of the Act was to exempt from tax only

such legal transactions as arose out of an enterprise or venture that had some other authentic object of its own, and were neither alien and hostile to the raising of revenue, nor designed to effect no change in legal interests except to defeat a tax.' . . ."

"The parties, each having a separate and real corporate personality, engaged in certain objective acts with the intent of creating legal rights and duties. We think that the occurrence of these acts affected their legal relations. Since the acts were real and the taxable entities cannot be characterized as sham entities, the transaction should not be disregarded merely because the transaction was entered into in response to a change in the governing tax law."

It is interesting to note that substantial tax savings of the decedent taxpayer did not prove out in operation. When, after taxpayer's death, the true value of the Miller Paint Co., Inc. stock was determined for tax purposes and decedent's stock therein was appraised at $34,778, to which was added the appraised value of the balance then due upon the notes, in the total sum of $40,690.42 and Federal Estate Tax paid thereon, the inclusion of the notes in the gross estate of the taxpayer substantially increased the Federal Estate Taxes payable by taxpayer's estate (Ex. 6-f, 7-g).

The Tax Court found (Tr. 40):

"No business reason dictated the formal method of capitalization undertaken."

and in its opinion, made the following statements in support of its position:

"* * * and we find no business purpose other than hope for avoidance of taxes, necessitating a

predominant debt structure and capital stock of a nominal declared value." (Tr. 49)

"The record in the instant proceeding satisfies us that there was no valid business purpose which dictated the gross undercapitalization here present. There seems to be no question that sound reasons existed for forming a corporation to carry on the business, which had been operating up to that time as a copartnership, but every advantage sought through incorporation, except that of the avoidance of taxes, could have been accomplished with equal facility and assurance of success by the more normal method of the issuance of capital stock of a par or declared value more nearly commensurate with the total amount permanently contributed to the corporation, and with which it was expected thereafter to conduct its affairs. * * *" (Tr. 52, 53)

"It may be quite true that the discovery of cancer in the decedent motivated the formation of the corporation so as to provide for continuity of the business in the event of death of one of the three brothers or in other circumstances. There was thus adequate business reason for incorporating the enterprise. But there was no business reason apparent on this record that called for such an absurdly low capitalization as petitioner asks us to accept at face. The argument that there was a business reason for incorporating the enterprise is merely a smoke screen that may be calculated to hide the absence of any business reason for attempting to achieve the result in the form that was employed." (Tr. 53, 54)

The Tax Court's ultimate conclusion of fact that there was no business purpose in the issuance of the notes is contradicted in its own opinion which holds:

(1) Incorporation of the partnership was motivated the a sound business purpose.

(2) The taxpayer was motivated by tax avoidance in using indebtedness rather than capital investment in stock to finance the company.

The opinion recognizes that the incorporation of the company was not a "sham." It disregards completely taxpayer's desire to remove his accumulated capital upon which he had paid income taxes from the business and his desire to create a fixed obligation of the corporation to repay to him or his estate, the capital loan to the corporation for its temporary use.

The opinion suggests that substantial investments in capital stock would have accomplished taxpayer's purpose. No explanation, however, is given as to how the same results could have been obtained by the use of stock as compared to that of notes.

What is more important, no suggestion is made by the opinion as to how a proposed issue of stock could be redeemed without making the redemption essentially equivalent to a dividend and so build into the corporation financing a confiscatory tax program which would destroy the value of the stock redeemed.

If it is assumed that, as the Tax Court holds, that tax avoidance is not a sufficient business purpose in formalizing the financing of the corporation by debt, the Tax Court then, at the same time, makes an implied assumption that taxpayers, generally, in conducting their business, have a "business purpose" to increase their taxes—a thesis rather hard to support in light of current business practices and high tax rates. As a matter of fact, a minimization of taxes is the principal con-

cern of every business in the United States today. The capitalist and the wage earner, whether at a lawyer's office or at the collective bargaining table continually ask the question, "What will I have after taxes."

If the Tax Court had found that it is good business for the taxpayer to cast his business transactions in a form that would increase his taxes, then petitioner could understand the holding of the Tax Court that the notes in question were "sham," but the opposite finding cannot possibly lead to the same conclusion. The very fact that notes were used instead of stock is consistent with common sense and this is evidence of the true intent of the taxpayer.

(b) All participants in the transaction consistently treated the notes as having reality and as evidence of indebtedness.

Without consistent treatment of the notes as evidence of debt, the finding of the Court that the intent of the taxpayer was to create a permanent capital investment instead of indebtedness, might have some credence.

Petitioner points out, however, that subsequent to the original transaction which set the form, the taxpayer, his brothers and the corporation consistently treated the notes as bona fide evidence of indebtedness. This is evidenced by the following facts:

(1) The final return of Miller Paint Co., a copartnership, reported a net gain of its fixed assets sold to the corporation, the net gain being the difference between the depreciated or adjusted value thereof and the

fair market value at the time of sale (Ex. 1-A). This gain in the amount of $6,683.68 was proportionately reflected and reported as a long term capital gain upon the partners' individual income tax returns (Ex. 2-B).

(2) All entries in the books of the corporation (Ex. 27, 28) reflected the existence of "notes payable," "Interest payable" and other entries consistent with the creation of indebtedness (Ex. 27, 28).

(3) Interest has been paid upon the indebtedness created since the date of incorporation (Tr. 123).

(4) The notes were separately inventoried in taxpayer decedent's estate and included in his Federal Estate Tax Return (Ex. 14, 6-F) and were treated by the Executor as something other than decedent's interest in the capital stock of the Miller Paint Co., Inc. (Ex. 14, 6-F).

(5) At no time was there any evidence of subordination of the debt to the claims of general creditors or any failure on the part of the note holders to demand and enforce payment according to the terms of the notes issued until double taxation upon the Herbert B. Miller Trust and the income beneficiary, Blance M. Miller on the same items of alleged income caused the income taxes to be confiscatory of any payment upon the principal of the notes (Tr. 122, 123).

(6) No evidence was introduced by the Commissioner to show false entries, false bookkeeping, deception, inconsistent treatment, fraud, or any other facts which would lead one to conclude that the manifest intent of the taxpayer was not the creation of an indebtedness.

(c) The corporation was adequately considering the underlying value of the capital stock in relation to the indebtedness, the earn-record of the business and the underlying value of the assets sold.

It has been the consistent position of the Commissioner that the corporation was inadequately capitalized because the nominal relation of debt to capital stock was approximately 174 to 1 at the time the corporation was organized. The Tax Court held in determining that the notes were a "sham" that there was "gross under capitalization here present" (Tr. 52). The Tax Court has erred in this conclusion because it failed to consider that:

(1) The earning record of the business gave every indication, at the time of the incorporation, that the notes could and would be paid off in accordance with the terms of the ordinary course of business and out of profit expected to be earned in a short period of years after the date of incorporation.

(2) The underlying value of the stock which exercised control and represented a proprietory interest in the concern as a going business after the corporation acquired the operating assets of the former partnership was greatly in excess of its subscription price of $3.50 per share.

(3) The earning record of the business for the years 1946 and 1947 and for all subsequent years was in fact sufficient to provide funds for the payment of and interest service upon the indebtedness created.

(4) The nature of the assets sold to the Miller Paint Co. were either subject to complete depreciation in a relative short period of time or would be self-liquidating in order to provide funds for the repayment of the notes.

Even the Tax Court concedes that the evidence shows that the earnings of the company would be sufficiently high and that in a relatively short period of time they would be able to withdraw the sums to make payments on the notes when due:

> "To be sure, the partners undoubtedly expected, as contended by petitioner, earnings to be sufficiently high in a relatively short period of time they would be able to withdraw sums approximating in amount their original capital investment without impairing necessary capital; and subsequent events seemed to prove this expectation to have been justified." (Tr. 45)

The Court, in making this finding, undoubtedly relied upon the copy of the Earning and Asset Schedule of Miller Paint Co., a copartnership, and Miller Paint Co., Inc. submitted in evidence as a Joint Exhibit 10-L. The Court also was aware that for the years 1946 and 1947, the years involved in the controversy, payments on the principal of the notes were made in the amounts of $7,500 and $10,000 respectively, when the only principal payment required by the terms of the note was $6,666.66. The Court also was probably impressed by the appraisement of the stock of Miller Paint Co. at $347.78 a share made as of a short period of a year and a half after the incorporation of the company.

Between January 1st and May 31, 1946, gross receipts of the Miller Paint Co. copartnership were $325,-528.09 (Ex. 1-A). The corporation had gross receipts of $403,809.06 between June 1st and November 30, 1946 (Ex. 4-D), and during the fiscal year ending November 30, 1947, gross receipts amounted to $864,540.75 (Ex. 5-E).

Earned surplus for the fiscal year ending 1946 was $19,487.88 and at the fiscal year ending 1947, $43,022.83 (Ex. 5-E). Analysis of the balance sheet of the corporation for these years indicates no impairment of capital caused by the payments on the notes.

These admitted facts are hardly an indication of under-capitalization.

The underlying fair market value of the assets transferred or acquired by a corporation has been taken into consideration to overrule's the Commissioner's contention of inadequate capitalization in at least nine cases: *Cleveland Adolph Mayer Realty Company*, 6 TC 730, Rev'd, 160 F. (2d) 1012 (CCA 6th); *Toledo Blade Company*, 11 TC 1079, Aff'd. 180 F. (2d) 357 (CA 6th); *New England Lime Company*, 13 TC 799 (1949); *O.P.P. Holding Corporation*, 30 BTA 337, Aff'd, 76 F. (2d) 11 (CCA 2nd); *BMC Manufacturing Corporation*, 11 TCM 376 (1952); *Earle v. W. J. Jones & Sons*, 200 F. (2d) 846 (CA 9th, 1952); *J. W. Walter, Inc.*, 23 TC No. 69 (1954); *Sheldon Tauber*, 24 TC No. 24 (1955); *Ainslie Perrault*, 25 TC No. 55 (1955).

In *Earl vs. W. J. Jones & Sons*, the capital stock amounted to only $1,000.00, but at the time of the re-

organization of the corporation one of the stockholders transferred to the corporation an option to purchase some mining property which had a fair market value of $50,000.00. Thereafter the stockholders advanced as loans to the corporation some $317,000.00, which the lenders later deducted as a bad debt. In allowing the bad debt deduction the Court said:

> "And the so-called capital contributions and loans in the instant case were not unidentified portions of a single investment, as was the situation in certain of the cases cited by appellants. The contribution of $1,000.00 to pay up the capital stock and the contribution of the mine property were recognized as wholly distinct from all other advances, which were expressly regarded as loans. And no inference adverse to taxpayer can be drawn from the fact that the stock certificates were not distributed until the advances had all been made.
>
> . . . .
>
> "Appellants also contend that this is a case of a corporate financial structure so overbalanced by indebtedness that it is lacking in substance for recognition for tax purposes. Considering (as we think it should be considered) the mine property as part of capital, the ratio of debt to capital after all advances had been made, and taking the most conservative estimate of the value of the mine value at the time of incorporation, was about six to one. We are not at all certain that such a financial structure is lacking in substance for recognition for tax purposes."

It is admitted that the stock of Miller Paint Co., Inc was appraised in the decedent's estate by a method which involved capitalization of the earnings of both the corporation and the partnership for a period extending back ten years (Tr. 30, Ex. 10-L). Assuming that

this stock had the same fair market value at the time that the corporation was organized the 300 shares of stock of which decedent owned 100 shares, in the Miller Paint Co., Inc., at the inception of the corporation, had a total value of $104,334.00. Indebtedness of the Company reflecting notes payable to the stockholders at its formation amount to a total sum of $174,571.26. Ratio of debt to capital was then approximately 1.67 to 1 based upon the following computation:

$$\frac{\text{NOTES: } \$174,571.26}{\text{VALUATION OF STOCK } 104,334.00} = 1.67$$

The going business value of the business was reflected in the stock valuation notwithstanding that as of the date of the death of the taxpayer there was an outstanding indebtedness owed to the stockholders in a total sum of $122,071.26. Petitioner submits that a ratio of debt to capital of less than 2:1 is not excessive.

In *J. W. Walter, Inc. vs. Commissioner, supra,* John W. Walter was operating a small electrical appliance business in New York, when he acquired a distributorship from Stewart Warner, after many months of negotiation. Expecting gross sales under the distributorship of $2,000,000 in the first year of operation with a net profit of 5% and a substantial increase in volume of subsequent years, he, after consulting with his attorneys and accountants, and being advised that his individual income tax would absorb most of the profit if he continued to operate as a sole proprietor, decided to incorporate, which he did, in 1945, transferring business assets to the corporation in the amount of $15,000 in

value and $10,000 in cash. For this consideration, the capital stock was issued to him. Shortly thereafter the corporation purchased the franchises held by him, personally, paying him therefor $100,000.00 in ten year 3½% debentures. In this case the Tax Court held that the debentures did not create an unreasonable debt equity ratio in petitioner's capital structure and found as a fact that the petitioner corporation received a valuable consideration for the issuance of the debentures by the assignment of the franchises from Walter, individually, to it. The opinion continues:

> "Nor can respondent's contention that these debentures were in fact equivalent to preferred stock be taken seriously. Unlike any of the cases in this field to which we have been referred, these debentures have none of the attributes of preferred stock. They fulfilled all the formal requirements of a short-term bond; they had a maturity date fixed in the reasonable future, ten years after the date of issuance; they afforded no basis for participation in management; and they imposed on petitioner a fixed liability to pay interest * * * irrespective of earnings or emergencies and at a modest rate of 3½% per cent. *Cf. Charles R. Huisking and Company,* 4 TC 595. No unusual unbalance in petitioner's ratio of equity capital to indebtedness resulted from their issue. *Cf. Mullin Building Corporation,* 9 TC 350, *aff'd.* (CA-3) 167 Fed. (2d) 1001; *Swoby Corporation,* 9 TC 887. As we have found, new property did flow to petitioner (corporation) upon their issuance. *Cf.* 1432 *Corporation,* 4 BC 1158, *aff'd.* (CA-2) 160 Fed (2d) 885. In these circumstances, that Walter and petitioner (corporation) subordinated the debentures to all other creditor claims, approximately two years after their issue date in order to obtain a favorable credit rating from Dun and Bradstreet, would not

> be significant. See *O.P.P. Holding Corporation,* 30 BTA 337, *aff'd.* (CA-2) 76 Fed (2d) 11; *Sabine Royalty Corporation,* 17 TC 1071; *Ruspyn Corporation,* 18 TC 769. Decision will be entered for the petitioner."

In *Sheldon Tauber vs. Commissioner, supra,* decided approximately four months after the *Walter* case, the facts were these:

A partnership was operated by members of the Tauber family, who, by virtue of excessive withdrawals by some of the partners, owned widely varying shares of the net worth of the partnership. In 1946 they organized a corporation with $100.00 worth of stock owned equally by the four partners. The corporation then purchased the assets of the partnership for their net worth, the notes given therefor being distributed to the partners in accordance with their remaining investment in the partnership.

These notes were paid off within two and one-half years and the Commissioner sought to treat such payment as the payment of dividends, upon the premise that a corporation with capital stock of $100.00 and indebtedness of $209,453.38 was thinly capitalized.

The Court found that in view of the prospects of the business, the contracts which it had on hand, and other business factors, the actual value of the business transferred to the corporation was $150,000.00 in excess of their indebtedness of $209,453.38. It concluded, therefore, that the corporation had as capital, not merely the $100.00 in cash paid for the stock, but also $150,000.00 in additional value, as contrasted with the $209,453.38

in notes, and that therefore, "the total capital of the new corporation could not fairly be called 'thin'."

The Court, after pointing out that the indebtedness in effect merely equalized prior excessive withdrawals by some of the partners, concluded that:

> "The notes evidenced amounts owed and cannot be regarded as evidence of capital of the corporation. The facts in this case amply distinguish it from those cited by the Commissioner in which evidences of indebtedness issued by a corporation were held to be equivalent of stock because of thin capitalization, that is, unreasonable disproportion between the amount of stock and the amount of other securities issued by a corporation for property. The Commissioner is thus left with nothing to support the deficiencies which he determined."

The case continues with a discussion of the Commissioner's alternative contention that a capital gain was realized upon the exchange of the property for the notes, to the extent of the value of the notes. In this respect, the Commissioner was adopting the same position that the Millers adopted in our case, in their determination that a capital gains tax should be paid as a result of the transaction. In the *Tauber* case, however, it was held that the Commissioner had failed to sustain his burden of proving an affirmative position, and that no capital gains tax was due.

In *Ainslie Perrault vs. Commissioner, (supra)* each of two brothers who were equal partners, subscribed and paid $2,000.00 in cash for all of the stock of a new corporation. The two brothers then transferred a portion

of the partnership assets valued at $1,026,951.32 to the new corporation, which assumed partnership liabilities of $53,862.52, and agreed to pay the partners $973,088.80 in four installments with interest on the last three installments at 3%. No notes were issued and the indebtedness was created by the terms of a purchase contract. At the same time, the corporation acquired from the partnership orders or unbilled items and good will, having a substantial value of several hundred thousand dollars.

The Commissioner reasoned that if the purchase agreement was taken at its face value, then the ratio of indebtedness to capital was 1026 to 2, which he, in effect, said was so "terrific" as to demonstrate that what in form is indebtedness should in substance be considered capital.

The Court in holding for the taxpayer, stated:

> "We have not thought it necessary to determine the value of each separate asset that passed to the Corporation, but we have no hesitation in determining that they were of large value amounting to several hundred thousand dollars and constituted such an ample investment in the Corporation as to preclude any justification for holding under the thin capitalization doctrine that the transferred assets under the purchase agreement of January 5, 1948, should in substance be considered capital rather than a bona fide sale by the stockholders to the Corporation. John Kelley Co. v. Commissioner, 326 U.S. 521 (34 AFTR 314); Rowan v. United States, 219 F. 2d 51; Sun Properties, Inc. v. United States, 220 F. 2d 171; Sheldon Tauber, 24 T.C. — (May 9, 1955). We hold, therefore, that the transfer of assets under the agreement of January 5, 1948, does not come within the provisions

> of Section 112(b)(5), supra. So long as the Corporation was provided with adequate capital, as we have held it was, we know of no reason why the organizers of the Corporation could not sell other assets to the Corporation providing the selling price was not out of line with realities. Bullen v. State of Wisconsin, 240 U.S. 625 (3 AFTR 2944); John Kelley Co. v. Commissioner, supra."

How can the Tauber and Walter decisions, and particularly the Perrault decision, be rationalized with the Tax Court's decision in the case at issue?

Some attention should also be given to the nature of the assets sold to the corporation in return for the notes (Tr. 38).

First, $50,000 was cash, a quick asset subject to being used by the corporation and returned to the noteholders over a period of time.

Second, $89,328.84 were accounts receivable of the partnership which were collectible by the corporation in a relative short period of time and subject to the payment of $52,614.17 of accounts payable of the partnership, would produce over $36,000.00 in cash available for payments upon the notes.

Third, the inventory of $60,122.49, when sold at a profit by the corporation would produce more available cash for the repayment of the indebtedness. Using the fiscal year ending November 30, 1947, for example (Ex. 5-E) gross sales were $864,540.75 and the cost of goods sold was $616,412.58, leaving a gross profit on sales of $248,128.17 or a gross profit of a little less than forty

per cent. Applying this factor to the inventory of $60,000 would produce another gross profit of approximately $24,000.

Fourth, the depreciable or amortizable assets consisting of machinery, equipment, furniture, fixtures, delivery equipment, office equipment and unexpired insurance sold by the partnership to the corporation totalled $27,136.40. These assets would be subject to depreciation which, within a period of six years, at various depreciation rates, would provide a reserve of at least eighty per cent of the value thereof, which in turn, could be drawn upon for the payment of the indebtedness created by their purchase.

The *Miller* case does not involve a loan for the investment by the corporation in "permanent" assets as emphasized in the case of *Sam Schnitzer vs. Commissioner,* 13 TC 43 (1949), *aff'd. per cur.* 183 F(2d) 70, *Cert. denied,* 340 U.S. 911 (1950), where the proceeds of the alleged "loans" were used to erect a rolling mill.

The basically permanent assets, the real property consisting of the retail store and the factory was owned and rented to the corporation by the Miller Paint and Wallpaper Co., another copartnership consisting of the three Miller brothers (Tr. 25). The assets purchased by Miller Paint Co., Inc. from the Miller Paint Co. partnership were of such a nature that the passage of time alone would convert them into cash with which to repay to the indebtedness to taxpayer and service the interest upon the debt thereby created.

Some highly pertinent language appears in *Rowan vs. United States,* 219 F(2d) 51 (1955, CA-5). In holding for the taxpayer the Court said:

> "Many students of tax law have discussed the inadequately capitalized corporation, sometimes known as the 'thin corporation'. The Court, of course, recognizes the fact that stockholders who lend money to their own corporation obtain all the advantages of favorable tax treatment if the enterprise fails. But the court also recognizes that, entirely without reference to the incidence of taxes stockholders of corporations have always been free to commit to corporate operations such capital as they choose and to lend such additional amounts as they may elect to assist in the operation if that is their true intent, always thus reserving the right to share with other creditors a distribution of assets if the enterprise fails. It would obviously work an unwarranted interference by the courts in ordinary and perfectly proper business procedures for us to say that there can be established, as a matter of handsight, a ratio of stockholder owned debt to the capital of the debtor corporation. No stockholder could safely advance money to strengthen the faltering steps of this corporation (which, of course,) may be greatly t othe benefit of other creditors) if he is faced with the danger of having the Commissioner, with the backing of the courts, say, 'he had no right to launch a corporate business without investing in it all the money it needed, and investing in it the way that is most disadvantageous to himself, both as relates to taxation and as to other creditors.'
>
> "It is entirely within the competence of Congress to provide by statute for such ratio if it deems it advisable or necessary within the scheme of Federal taxation. It is not within our province to do so. Nor would it further the desirable end of certainty in taxes for us to do so."

> "In what we have said, we refer only to the situation wherein there is no evidence of an intent to make a contribution to capital other than the ratio between debt and stated capital. . . ."

Petitioner has no quarrel with the thesis of the Commissioner that the taxpayer expected that the principal of the notes would be paid out of earnings of the corporation but certainly this is not an unusual circumstance. Corporations, whether large or small, publicly owned or closely held, expect that their indebtedness, whether it is in the form of notes or debentures will be retired out of earnings. Corporations of all types, for more than a century, have generated their own capital by plowing back earnings into their business. It is part of the American business tradition which Congress has not yet changed by any specific enactment of its revenue laws.

A profitable money-making business, such as Miller Paint Co., in the years 1946 and 1947 engaged as it was, in supplying materials to a building and construction boom in the Northwest, flooded by new population during the war, needed little capital of the permanent type, as it could be reasonably expected that the profits of the company would be completely adequate, not only to repay its debt financing but within a period of a few years to generate its own capital out of accumulated profits. What the incorporators and stockholders of Miller Paint Co., Inc. contemplated at the time of the incorporation of the company came to pass and the very fact that the loans were being repaid more rapidly than the terms of the notes provided, shows that the judgment of the in-

corporators was correct in their conclusion that their permanent capital stock could be valued the minimum allowed by the laws of the State of Oregon and that there was no real risk in loaning operating capital to the corporation.

We are not dealing, in this case, with a bad debt deduction which has given rise to so many cases which discuss "thin incorporation." When a corporation fails and is unable to pay its debts, then it is easy, by hindsight, to make a finding that this should have been contemplated at the time of the formation of the corporation, and the sequence of events shows that there was substantial risk in loaning money to the corporation and there therefore the funds advanced were "risk capital".

Point 3

A finding that the notes are "sham" is beyond the issues raised by the pleadings.

The Tax Court's reasoning that the notes were sham is based upon three supporting reasons:

(1) The corporation was inadequately capitalized.

(2) There was no intention on the part of the organizing taxpayers that there was an indebtedness created which was intended to be repaid.

(3) The true intent of the taxpayers was only for the purpose of tax avoidance.

Assuming that the foregoing statements are true, we call to the Court's attention that the taxpayers, their at-

torneys and advisors have been guilty of a much more serious violation of the Internal Revenue Laws in that false and fraudulent minutes of the corporation were written up, false and fraudulent notes were issued by the corporation to its stockholders, and false and fraudulent income tax returns have been filed by the taxpayers.

In other words, the taxpayer is in effect charged with fraud with an intent to avoid payment of income taxes.

Examination of the Commissioner's answer (Tr. 20-22) discloses no charge of fraud or any affirmative pleading whatever charging that the notes were "sham". Under the circumstances, the pleadings in this case will not support the Tax Court's finding that the notes were "sham".

The Internal Revenue Code (1939) provides:

> "Sec. 1112. Burden of Proof in Fraud Cases.
>
> In any proceeding involving the issue whether the petitioner has been guilty of fraud with intent to evade tax, the burden of proof in respect of such issue shall be upon the Commissioner."

Petitioner submits that the respondent has not maintained this burden by a preponderance of clear and convincing evidence.

Point 4

Sec. 112(b)(5) of the Internal Revenue Code of 1939, involving nonrecognition of gain in certain transfers is not applicable to the facts herein.

Some decision on this point is mandatory if only because the basis of the assets transferred to the corporation affects the earned surplus of the corporation for the years in question.

Internal Revenue Code (1939) provides:

"Sec. 112. Recognition of Gain or Loss

* * *

"(b) Exchanges Solely in Kind.—

* * *

"(5) Transfer to Corporation Controlled by Transferor.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation, and immediately after the exchange such person or persons are in control of the corporation; but in the case of an exchange by two or more persons this paragraph shall apply only if the amount of the stock and securities received by each is substantially in proportion to his interest in the property prior to the exchange. * * *"

From the *Regulations; Sec. 29.112 (a)-1* we quote:

"SALES OR EXCHANGES.—The extent to which the amount of gain or loss, determined under section 111, from the sale or exchange of property is to be recognized and is governed by the provisions of section 112. The general rule is that the entire amount of such gain or loss is to be recognized.

"An exception to the general rule is made by section 112(b)(1) to (5), inclusive, in the case of cer-

tain specifically described exchanges of property in which at the time of the exchange particular differences exist between the property parted with and the property acquired, but such differences are more formal than substantial. As to these, the Internal Revenue Code provides that such differences shall not be deemed controlling, and that gain or loss shall not be recognized at the time of the exchange. The underlying assumption of these exceptions is that the new property is substantially a continuation of the old investment still unliquidated; . . . "

"The exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception. Nonrecognition is accorded by the Internal Revenue Code only if the exchange is one which satisfies both (1) the specific description in the Code of an excepted exchange, and (2) the underlying purpose for which such exchange is excepted from the general rule. The exchange must be germane to, and a ncessary incident of, the investment or enterprise in hand. The relationship of the exchange to the venture or enterprise is always material, and the surrounding facts and circumstances must be shown. As elsewhere, the taxpayer claiming the benefit of the exception must show himself within the exception.

"To constitute an exchange within the meaning of *Section 112(b)(1) to (5),* inclusive, the transaction must be a reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only."

Petitioner submits that facts in the case do not fall with the exception to taxability as outlined in Sec. 112 (b)(5) I.R.C. for the following reasons:

(a) The stock issued by the corporation was paid for in cash, not from the partnership assets but from the personal bank accounts of the partners.

(b) No "securities" were ever issued by the corporation, within the meaning of the Internal Revenue Code.

(c) The evidence indicates that there was no "exchange" of property but rather a sale by the partners of certain assets to the corporation in return for cash consideration represented by the indebtedness created by the notes.

The note in question upon which payments were made was due in its entirety within five years from the date of its issuance and was in fact paid in full within four and one half years. As such it was a short term note which bore a fixed maturity date, was secured by a chattel mortgage, and was not subordinated to the claims of other creditors. In all ways it fell within the authority of the following cases which hold that short-term notes bearing a fixed maturity date and secured by a chattel mortgage, were not "securities" within the intent and meaning of Sec. 112(b)(5) I.R.C.; *Neville Coke and Chemical Co.*, 3 TC 113, *aff'd.* 148 F2d 599; (CCA 3rd, 1945); *Courtland Specialty Co. vs. Commissioner*, 60 F(2d) 937 (CCA 2d, 1932) *cert. denied* 288 U.S. 599, 77 L. Ed. 975, 53 S.Ct. 316 (1933); *Sisto Financial Corp.*, 47 BTA 425 *aff'd on this point*, 139 F(2d) 253 (CCA 2d, 1943); *Seiberling Rubber Co.*, 8TC 467, *Revsd. on other grounds* 169 F(2d) 595 (CCA 6th, 1948).

In order to hold that the note in question was a "security" the Court would have to reason that the note was of such dignity and formality to be classed as a "security" under authority of such cases as *Burnham vs. Comm.*, 86 F.2d 776 (CCA 7th, 1936), which involved notes having a ten year life. In the case at issue the notes were such as are issued everyday in the ordinary course of business by closely held corporations. They were not in registered form, were not issued in series, and bore on their face no indication that they were designed to be offered by the holders to and negotiated to the general public.

In the words of the Regulations previously quoted, there was no "reciprocal transfer of property, as distinguished from a transfer of property for a money consideration only". The notes were more evidence of the cash consideration for the sale of the partnership assets. Therefore, the transaction did not fall within the exception of the general rule that such transactions are subject to the recognition of gain and loss for tax purposes.

The regulation quoted, specifically points out that the nonrecognition of gain or loss is an exception to the general rule which must meet the specific description in the Code of an excepted exchange and points out that "the taxpayer claiming the benefit of the exception must show himself within the exception."

If the Court determines that the notes have validity and are not "sham" but are evidence of indebtedness,

there is no question that Sec. 112(b)(5) is inapplicable. If, on the other hand, the Court agrees with the Tax Court that the notes were "sham" and had no existence, the question still remains as to whether or not the assets transferred to the corporation represent capital stock or paid in surplus.

The Statutory Notice of Deficiency (Ex. H) and the Thirty Day Notice of Proposed Deficiency (Ex. I) show that the Commissioner treated the "loans" as paid in surplus which is in accord with the fact that the stock was not issued in exchange for the partnership assets.

If it is paid in surplus, then it should be paid in surplus to the extent of the assets' fair market value at the time of their transfer to the corporation. Sec. 112 (b)(5) would still have no application.

Point 5

Even if the notes are "sham" the repayment thereof does not constitute a taxable dividend, even though earned surplus is present.

The Internal Revenue Code (1939) provides:

"Sec. 115. Distributions by Corporations.

"(a) Definition of Dividend.—The term 'dividend' when used in this chapter * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the

taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made. * * *

"(b) Source of Distributions.—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

(c) Distributions in Liquidation.—Amounts distributed in complete liquidation of a corporation shall be treated as in full payment in exchange for the stock, and amounts distributed in partial liquidation of a corporation shall be treated as in part or full payment in exchange for the stock. The gain or loss to the distributee resulting from such exchange shall be determined under section 111, but shall be recognized only to the extent provided in section 112. In the case of amounts distributed (whether before January 1, 1939, or on or after such date) in partial liquidation (other than a distribution to which the provisions of subsection (h) of this section are applicable) the part of such distribution which is properly chargeable to capital account shall not be considered a distribution of earnings or profits. If any distribution in partial liquidation or in complete liquidation (including any one of a series of distributions made by the corporation in complete cancellation or redemption of all its stock) is made by a foreign corporation which with respect to any taaxable year beginning on or before, and ending after, August 26, 1937, was a foreign personal holding company, and with respect to which a United States group (as defined in section 331(a)(2) existed after August 26, 1937, and before January 1, 1938, then, despite the foregoing provisions of this subsection, the gain recognized resulting from such distribution shall be considered as a gain from the sale or exchange of a capital asset held for not more than 6 months.

> "(g) Redemption of Stock—(1) If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."
>
> "(i) Definition of Partial Liquidation.—As used in this section the term "amounts distributed in partial liquidation" means a distribution by a corporation in complete cancellation or redemption of a part of its stock, or one of a series of distributions in complete cancellation or redemption of all or a portion of its stock.

As previously pointed out, the Commissioner treated the loans as paid in surplus. If this is the Commissioner's theory, then the question arises whether the repayment to the stockholders of such paid in surplus is a dividend or essentially equivalent to a dividend within the meaning of Sec. 115 I.R.C. (1939).

Keeping in mind that the notes in question are enforceable obligations under the laws of the State of Oregon and that repayment of the principal must be made, because of the contractual obligations involved, it would seem to the petitioner that proper accounting procedures would be to charge the repayment of the principal of the loans for tax purposes to the paid in surplus account which the Commissioner has arbitrarily set up for tax purposes. As such, such payments

would clearly be a return of capital, not taxable as a dividend to the taxpayer. It must be remembered that from all times on, after the notes are declared to be sham and the debt is ceased to be recognized as bona-fide that the accounting procedures of fictional character are completely under the control of the Commissioner.

If, however, the correct solution to the problem is to treat the notes as consideration for the capital stock of the corporation, then the repayment of the notes would result in an involuntary partial liquidation of the corporation each time that a payment was made upon the principal of the notes. In such event, the partial liquidation would be one governed by the ordinary gain and loss provisions of the Internal Revenue Code.

Whether a partial liquidation or a cancellation of stock is essentially equivalent to a dividend under Sec. 115 (g)(1) I.R.C. 1939, always depends upon the facts and circumstances of the case. In the instant case, the corporation may be reasoned to be contractually bound to redeem its stock (i.e. notes) under a plan which would return to its stockholders (i.e. noteholders) their investment within a period of six years.

Petitioner has found no case which discussed the rationale of taxation of the principal of the repayment of notes which have been held without substance under a theory of "thin incorporation."

For authority that not all distributions to a stockholder out of earned surplus of a corporation are tax-

able as dividends, petitioner calls to the attention of the Court, the case of *Zenz vs. Quinlivan,* 213 F(2d) 914, (1952) *Comm. acq; Rev. Rul.* 54-548 1RB 1954-42, which holds that a distribution of an amount equal to the earned surplus of a corporation to a stockholder in return for a redemption of her stock was not essentially equivalent to a dividend. In this particular case, the redemption extinguished all interest of the taxpayer in the corporation, but the principle is there to be recognized.

The difficulty in cases of this kind stems from the fact that the Commissioner may say that the true facts of the case are such only for the purpose of taxation. In the case at issue this does not go very far in solving the problems with which your petitioner is faced.

Your petitioner is also the Trustee of the Herbert B. Miller Estate and has in his possession the $29,000 note, the principal of which is a capital asset of the trust estate. No decision of this Court or of the Tax Court is going to effect its enforceability against Miller Paint Co., Inc. as a matter of Oregon Law including the law of trusts. When the principal is collected upon this note, it will have to remain as a capital asset of the trust estate and cannot be distributed under the terms of decedent's will to Mrs. Blanche Miller, the income beneficiary. Examination of Exhibits 20, 21, 22 and 23 reveal that the Commissioner considers principal payments upon the Miller Paint Co. notes to be dividend income both to the trust and to Mrs. Miller, even though Mrs. Blanche Miller cannot possibly receive distribution of this alleged trust income under Oregon law.

As long as the Commissioner has decided to rearrange the legal relationships for tax purposes between the decedent taxpayer and the Miller Paint Co., he should be consistent by the terming the repayment of the principal of the notes essentially a return of capital to the taxpayer involved, as neither the corporation nor the trustee have now any control over the legal relationships between them.

CONCLUSION

Cases of the nature of the one involved in this appeal always seem to rest upon a finding of fact that the Commissioner of Internal Revenue knows more about what was actually done and intended in the formation of a corporation than the principals did themselves. It is recognized that the Commissioner is motivated by desire to equitably collect taxes and to interpret every taxable transaction in a light most favorable to the Government. He has hesitated, however, to claim fraud on the part of the taxpayer. We think the reason is obvious.

The terms "thin incorporation" and "inadequate capitalization" were unknown to income tax law at the time of the transactions involved in this case. Debt financing of small, closely held corporations was and still is present in a majority of all corporations formed in Oregon. Until Congress interdicts debt financing by a change in the income tax law, which would apply without discrimination to all corporations, large and small,

Miller Paint Co., Inc. should not be singled out for this special tax treatment.

The petitioner submits that the Honorable Court should face business realities, should re-examine the Tax Court's position with respect to debt financing of corporations and hold that, in the absence of a finding of fraud on the part of the incorporators motivated by tax evasion as distinguished from tax avoidance, that the form of corporate financing is of no concern to the Commissioner of Internal Revenue.

Respectfully submitted,

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